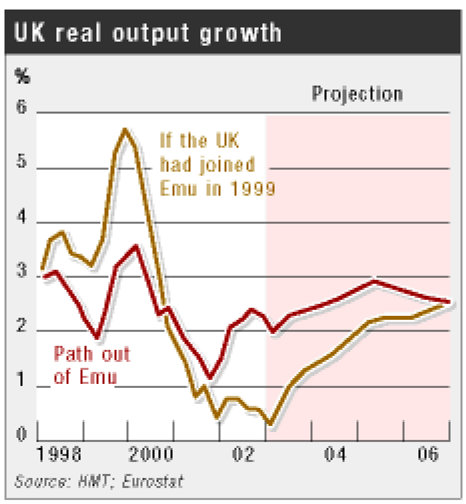
Comment & analysis

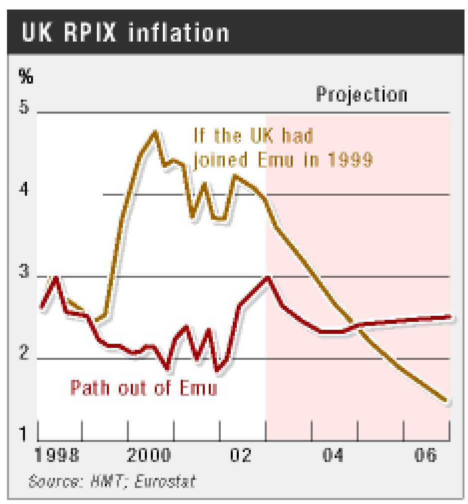
Martin Wolf: The perfect result for a sceptical nation

By Martin Wolf
Published: June 9 2003 21:04 | Last Updated: June 9 2003 21:04

Never in human history can so many have written so much for so small a result. After publishing 18 detailed studies, plus a 246-page assessment, the Treasury's answer on UK membership of the European single currency remains what it was in 1997: "not yet". It is a warmer "not yet". But whether and when the UK will join remains obscure. The most plausible conclusion is that it is not going to happen in the next few years.

Tony Blair has won on the procedure, while Gordon Brown has won on the substance. The chancellor continues to hold the keys to the door marked "entry". This decision is to remain "clear and unambiguous" and be made on the basis of the national economic interest and the stability of the British economy. Meanwhile, the prime minister has forced the chancellor to approach the door again in less than a year. As the chancellor said on Monday, "we will report progress in the Budget next year" and then decide whether to make a further assessment of the five tests. This issue is permanently in play. It will blight politics and create ceaseless uncertainty for business.





Yet the question remains whether the chancellor is likely to change his mind in the near future. That can be addressed, in part, by looking at how he has gone about saying "not yet". There have always been three big decisions: the first is on the long-run gains of currency stability; the second is on the costs of the loss of exchange rate flexibility and monetary autonomy; and the third is on the transition. The Treasury's assessment of its tests throws light on its attitude to these questions.

On the first, the Treasury is remarkably positive. It cites, with approval, recent work underlining the likely positive impact of a currency union on trade and economic activity. Intra-eurozone trade has increased by up to 20 per cent in recent years. This, argues the Treasury, supports the optimistic view that the UK's total trade with the eurozone might rise by as much as 50 per cent over 30 years. This, it also suggests, would raise gross domestic product by between 5 and 9 per cent - an increase in the growth rate of one quarter of a percentage point a year. To put it another way, the Treasury suggests that the economy might enjoy what amounts to an additional two to four years of economic growth crammed into a 30-year period.

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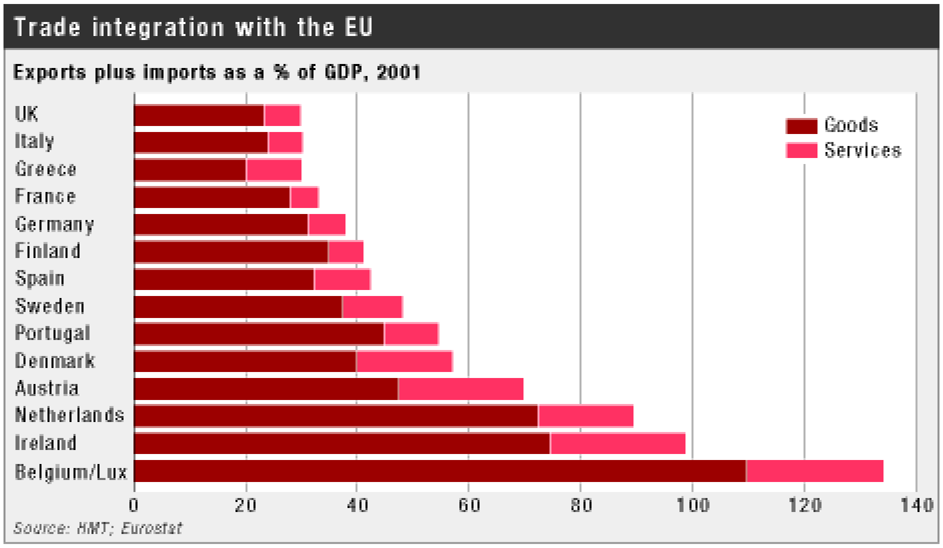
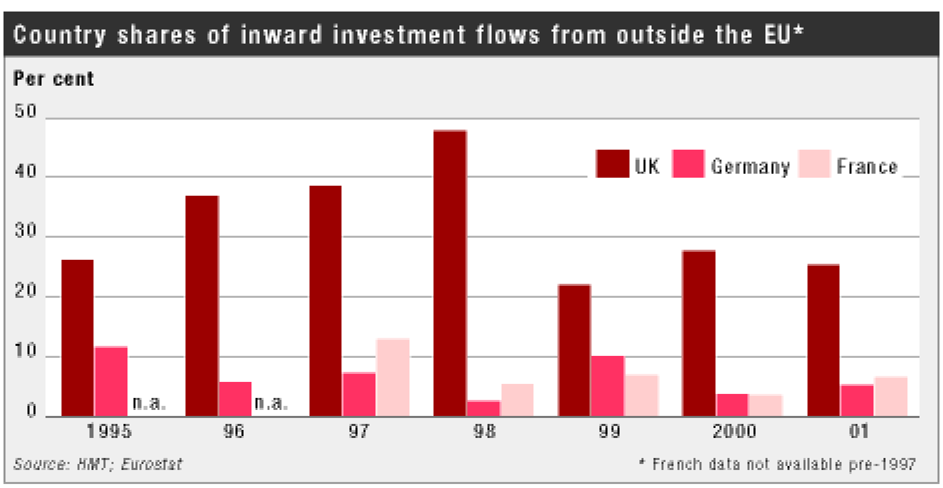
The price, however, would be loss of monetary autonomy and exchange rate flexibility. The Treasury's view has long been that only with a high degree of convergence between the UK and the eurozone, a satisfactory degree of flexibility in the British and eurozone economies and a fiscal and monetary policy regime in the eurozone as good as its own would it be wise to recommend entry. On all these points it sees progress - but insufficient to recommend entry.



The Treasury has been right to make much of these issues. Just how right is indicated by a simulation exercise that indicates what would have happened if the UK had joined in 1999 (see charts). It shows that output and inflation would have been destabilised. The decision not to join was correct.

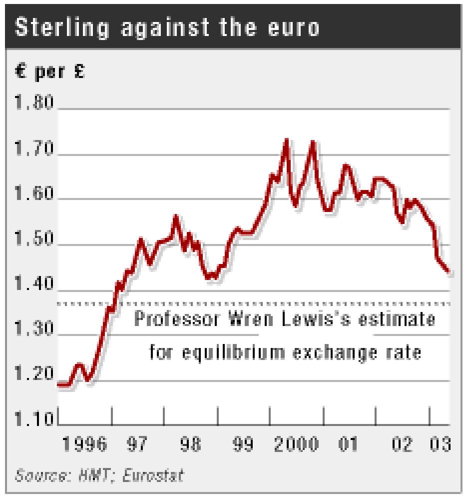
Yet, today, as the Treasury remarks, the UK exhibits a greater degree of cyclical convergence than some eurozone members demonstrated in the run-up to the start of currency union in 1999. The UK also meets all the treaty conditions for inflation, interest rates, debt and fiscal deficits. But short-term interest rates are still 1.75 percentage points higher than in the eurozone and, argues the Treasury, there remain structural differences, above all in housing.

The British housing market, it notes, has a high level of mortgage debt at variable rates. This makes UK households exceptionally interest-rate sensitive. The supply of houses expands very slowly, while real prices have been rising faster than in the big eurozone economies. This, in turn, is part of the explanation for the far greater dynamism of consumption, particularly in recent years.



The housing market is not all the Treasury worries about. It is concerned also about the European Central Bank's failure to introduce a symmetrical inflation target and about the defects of the stability and growth pact, which governs the eurozone's fiscal policy. In effect, the Treasury believes the eurozone is not good enough to join the UK. All this means that not only are convergence and flexibility inadequate at present but also that, in giving up its own monetary and fiscal arrangements for the eurozone's, the UK would be switching from a better arrangement to a worse one.

Then there is the final issue of transition. Here the Treasury has some good news. In a background study by Simon Wren-Lewis of the University of Exeter, it is suggested that €1.37 would be a sensible exchange rate for the pound. This, as it happens, is close to today's rate. If this lasted, the principal transitional shock would come from the change in interest rates. Even so, the assessment suggests that the percentage cut in government spending needed to offset this interest rate gap, with no currency overvaluation, is still 6 per cent. Transition may have become a smaller problem. But, since convergence is incomplete, in the Treasury's view, the costs of transition are still not zero.



What might change in the years ahead? The Treasury has decided that the UK still has to meet the two tests of convergence and flexibility. Domestically, the government is committed to doing something to reduce the instability generated by the housing market. Equally, it intends to increase the regional flexibility of pay. These changes will take some time. But they are at least under the government's control. So, too, are its plans to introduce a new, symmetrical inflation target of 2 per cent on the harmonised index of consumer prices. But the government also wants changes in the eurozone - changes in the way the monetary and fiscal systems work and increases in flexibility. These are not in the government's control. They may not come soon - or at all.

Where does this leave us? In limbo, is the answer. That is also where we are likely to remain for some time. I, for one, think that is the right decision for a country as sceptical as the UK about the implications of the currency union. And if you doubt this scepticism, take a look at how the government has approached this decision. It is because of British doubts that it has stressed the need for a clear and unambiguous assessment only of the economics. Not so much through its substance as through its style, this entire exercise shows that the British are not ready for membership.

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